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## CURRENCIES AND CREDIT MARKETS

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No.193/ May, 1989

To a considerable extent, the dollar's movements have reflected the U.S. macroeconomic imbalances, the excess of domestic spending over output, and the shortfall of national saving relative to investment. ...In any event, the record levels of borrowing against the limited pool of domestic private saving played an important role in pushing up the dollar's exchange value against other currencies by keeping U.S. real interest rates high by historical standards.

Seventy-fourth Annual Report  
Federal Reserve Bank of New York

### HIGHLIGHTS

What's behind this latest rally of the U.S. dollar? Is it something fundamental? An analysis of psychological, cyclical and monetary, and internal and external economic fundamentals leads to the conclusion that it is only psychological and short-term monetary factors that still dominate.

While large budget deficits, current account deficits and rising inflation are an infallible recipe for currency depreciation in the long-run, over the short-run these factors tend to impart temporary strength through the channel of a monetary squeeze.

Most alarming, however, is the drastic deterioration of internal and external fundamentals on the supply-side of the U.S. economy. From this vantage point, it must be said that the long-term outlook for the U.S. economy and the U.S. currency is worse than ever.

Experience suggests that a downturn in any currency usually follows signs of a weakening economy since that development is viewed as a precursor of easier money. Given beginning evidence of the former, the watch now turns to evidence of the latter. And that can only be a matter of time.

One might remember how hard currencies became hard currencies. There were both supply-side and demand-side causes. On the supply-side were high savings, investment spending and productivity growth. The demand side was evidenced by greater monetary and fiscal discipline as compared to the rest of the world.

Rising inflation in the United States cannot be dismissed as being merely the result of either temporary or cyclical factors. A sharply tightening labour market and lagging productivity growth adds an underlying bias to the upside.

Why couldn't the soft-landing of 1984 happen again this time? An assessment of 1984-85 leads to the conclusion that today's economic conditions couldn't be more different.

## WAYWARD BUT EVER ONWARD

World financial events continue to confuse and deflect any measure of normality. One begins to get cross-eyed. With one eye trained on currency markets and the other on economic news emanating from the United States and Germany, it is indeed hard to gain a clear focus on what one sees. In the past, dollar strength coincided with either rising U.S. interest rates or evidence of favourable economic or trade data. At the moment, there is no sign of either. In fact, much to the contrary, U.S. trade improvement has stalled while the economy weakens coincident with rising inflation. Even though all this is a far cry from recent optimistic forecasts, the dollar continues in its time-warp.

On the other side of the Atlantic, the hide-bound German economy is delivering astoundingly good economic results and bursting trade figures. Last month, the German unemployment rate declined dramatically from 8.4% to 7.9%. Even more staggering was the news that West Germany's first-quarter trade surplus rose 44% compared to a year ago. For the quarter as a whole, merchandise exports boomed 22% and imports by a lesser 17%. Imagine where the dollar would be if that immense export boom applied to the United States instead.

Anyway, recent experience suggests that Wall Street and other world markets are focusing on only one factor almost to the complete disregard of anything else. And that one thing, virtually to the point of obsession, is the high interest rate differentials favouring the dollar supported by the idea that the U.S. Fed cannot respond to a weakening economy because of higher inflation.

During past months, our assessment of the U.S. economy has been at striking odds with the consensus view. The majority saw a strong economy that would have to be curbed by higher interest rates. We saw a slowing economy and thought that, sooner or later, markets would anticipate a gradual monetary easing. In fact, the economy is tapering off. But apparently, the slowdown is not yet perceived as severe enough to most observers.

## A REMINDER: THE ORWELLIAN YEAR OF 1984

In many ways, recent market exuberance reminds us of what happened when the U.S. economy unexpectedly faltered in 1984. Then too, the economy initially accelerated in the first quarter, with real GNP rising at an annual rate of 10.1%. The recovery was then only 18 months old and nobody thought a sudden end was possible. Everything pointed to a buoyant economy. Housing starts had jumped to an annual rate of 2.2 million - the strongest construction boom since 1978 - and auto sales were up 33% over the year before. The Commerce Department's survey of business spending on plant and equipment was revised upward from 9.6% to 13.6%.

Worried over the "very strong" economy and whether production "bottlenecks" might develop, the Fed's Open Market Committee (FOMC) ordered a measured tightening of credit in late March. The Fed funds rate was gradually pushed from a little above 9.5% to almost 12%. Soon after, on April 6th, the Federal Reserve Board raised the discount rate to 9%, the first change since December 1982. As both short and long-term interest rates moved up sharply, the dollar followed suit.

A greater monetary tightening might well have been undertaken, given continuing strong economic data. But the policy makers at the central bank were inhibited by another event: the collapse of the Continental Illinois National Bank in Chicago. Yet, at a meeting on August 21st, the FOMC specified no easing in reserve pressure. Nobody at that time had yet realized that the boom had already faded into a mere whimper. By the fall quarter, when the Fed majority still refused to ease, the economy was limp and growing at a lacklustre annual rate of 1.3%, following the spurt of 10.1% in the first quarter and 7% in the second.

Despite all of these oversights on the part of the Fed committee members, a "soft-landing" ensued. One man had chosen to disobey the board's directives. It was Paul Volcker, the Chairman of the Fed. He gave instructions to ease, and judging from what then happened to interest rates, one can only conclude that it was an aggressive easing. By election day in early November, the Fed funds rate was trading at 9.7% - down two full percentage points. By year-end, for the first time in nearly six years, the Fed funds rate had dropped to around 8%. Long-term Treasury bond yields began a long decline from a peak of 13.5% in mid-1984, falling to around 11.5% at year-end, with much bigger declines yet to follow.

**The Lessons of 1984.** The episode of 1984 has been on our mind for two reasons. First, the experience once again shows how long it can take to recognize signs of a slowdown in the economy. Secondly, the trend of U.S. dollar might provide some insight. Believe it or not, even while U.S. interest rates dropped like a stone, the dollar skyrocketed until the end of February 1985 when the Bundesbank finally stopped its advance with heavy interventions.

Today, too, there is a school of thought that expects a rising dollar even in an environment of falling interest rates, or in fact, precisely because of lower rates. This view seems to be held by the inflation and bond optimists. In their view, the present flare-up in inflation is nothing more than the typical lag that occurs at the end of a recovery.

Over time, and assuming that the Fed does not release the brakes before inflation is tamed, they see rather drastic falls in long-term interest rates to levels well below 8%. With the bait of potential bond market returns in the 20%-plus range over the next 12 months, they think masses of foreign investors will be lured and, in so doing, will drive up the dollar.

## A RETURN TO THE FUNDAMENTALS OF CURRENCY ANALYSIS

What's behind this latest rebound of the U.S. dollar? Is it something fundamental or just another speculative bubble that is destined to burst some day? Has the long-term downtrend of the dollar finally been broken by the "supply-side revolution" that is supposed to be taking place in the United States? Many people, above all the chartists, apparently answer this question in the affirmative.

In assessing the prospects for the U.S. dollar over the near and longer term, one must distinguish between three different kinds of influences:

- 1) psychological;
- 2) cyclical and monetary; and,
- 3) internal and external fundamentals.

Presently, as we've mentioned, it seems that exchange rate movements are mainly determined by interest rate differentials, as was the pattern in 1988. Yet, differentials alone, without any other influences, would not have this power. One might remember that during the 1970s, higher U.S. interest rates failed to stem the fall of the dollar. An additional factor is always required to give interest rate differentials their potency. And as a matter of historical fact, hard currencies have always tended to rise with low interest rates and have not required the aid of rising rates.

In hindsight, it is easy to recognize the long-term downtrends and uptrends of currencies. All-the-same, time and time again these trends were often interrupted by temporary but sometimes wide counter-swings. On closer examination, these swings were mainly associated with changes in cyclical, monetary and psychological conditions.

During the first post-war crisis of the dollar in the 1960s, it was a combination of low interest rates and concern over unemployment and the low growth prospects of the U.S. economy (as compared to dynamic growth in Europe) that led to dollar weakness, even in spite of large U.S. current-account surpluses. In many ways, the situation today is virtually the mirror image of that period in the 1960s.

### THE PSYCHOLOGICAL DOLLAR PROP

From what one generally reads and hears about the U.S. economy, one can only conclude that market sentiment remains positive. By most of the usual yardsticks, the U.S. economy has in fact performed extremely well in recent years. The recession that occurred in 1981-1982 was followed by six years of virtually uninterrupted recovery. Employment grew by 18 million. The unemployment rate, a little over 5% today, is now near 15-year lows. Many think that inflation has been permanently wrung out of the economy by the long and brutal monetary squeeze of 1979-1982. From this perspective, relatively high U.S. interest rates are interpreted as just another sign of strength, reflecting the

superior dynamism of the U.S. economy compared to the apparent sluggishness of European economies.

Undoubtedly, this widespread but superficial perception of a strong and healthy U.S. economy is the basic prop for the dollar and U.S. financial markets. This mind-set has created an atmosphere in which all news is good news. Until very recently, a bullish scenario for the dollar had been built on the notion of a strong economy and rising interest rates. Now, however, an optimistic view is being squared on the belief that U.S. stocks and bonds will rally sharply if the U.S. economy cools off, and that this is supposed to attract foreign capital that will drive up the dollar.

One might remember that a rise in inflation to the present-day rates of around 5% used to suggest the prospect of tighter money and therefore depress the securities markets. This time, it has the opposite effect. Focusing on the link between tighter money and a strong dollar, the markets' logic has been turned upside-down. Based on the argument that a strong currency attracts foreign investors, Wall Street has fallen in love with tight money and celebrates with buoyant markets. A stronger dollar has become both a tonic and panacea.

To be quite frank, the logic behind all this is so twisted and so obvious that it isn't even worthwhile to explore these arguments. Once again, Wall Street is taking leave from reality. All these theories serve one purpose: to build an optimistic case for the U.S. economy, the U.S. financial markets and the dollar. And to give credit, so far these fairy tails have been successful.

Although attention tends to focus on the U.S. dollar in this respect, the currencies of other countries showing large or rapidly rising current-account deficits are faring just as well, if not better. Recent examples here include the Canadian dollar, the Italian lira, the Spanish peseta and the Finnmark. The common features of all these countries include overheating economies, strong credit demand and high interest rates. The same perverse result has followed: capital inflows have exceeded the requirements of large external deficits and bolstered currencies. In a sense, it is revealing that observers only speak of "paradoxical" and "artificial" strength in the case of the Italian lira and the Spanish peseta, but not in the case of the dollar.

#### THE INFLUENCE OF CYCLICAL AND MONETARY CONDITIONS

Now to the second major influence on currency markets: namely, the change in relative cyclical and monetary conditions between countries. As already mentioned, the long-term downtrend of the U.S. dollar against the group of hard currencies has occurred in the face of frequent counter-swings. The most obvious force behind these swings have been cyclical differentials and associated differentials in monetary conditions.

The dollar tends to experience weakness during times of U.S. business downturns and strength during periods of a cyclical recovery relative to the rest of the world. That is particularly so around the peak of the U.S. cycle. In other words, there has been a pro-cyclical tendency at work within currency markets. This influence is greatest when business cycles between the United States and Europe are de-synchronized.

Historical examples of cyclically-driven dollar weakness are found in 1960, 1970-1971, late-1974 through early-1975, and late-1982. Examples of cyclical dollar strength include 1969, mid-1974, late-1979, 1982-1984 and 1988.

Actually, the tendency for currencies to move in cyclical fashion is as old as the exchange markets themselves. In this respect, not much is new. But, what is new is the fact that this principle still holds even in the face of the outsized imbalances that prevail today. However, one must also recognize that these unprecedented global imbalances are in turn accompanied by unprecedented interest-rate differentials.

The link of connection, although it may be hardly necessary to explain, are the relative monetary conditions. Tight money and high interest rates pull foreign capital and "hot money" into a booming economy, in particular when growth may be heavily credit-fed. Changes in relative cyclical and monetary conditions emerge as a reliable and key influence on exchange rates.

However, there are two complicating factors that may delay the expected reaction of currency markets. One of these is monetary policy. Given the strong inflationary pressures that face most deficit countries, interest rates may remain relatively high and possibly still rise, even after the peaking of their economies. This perception has apparently dominated exchange markets in the case of most of the aforementioned currencies, and not just the U.S. dollar.

While large budget deficits, current account deficits and rising inflation are an infallible recipe for currency depreciation in the long-run, note that in the short-run these factors tend to impart temporary strength through the channel of a monetary squeeze. Perversely enough, inflation may keep the dollar high, for a while yet.

From a cyclical perspective, it would become most critical for the dollar if later this year or earlier next year the European and Japanese economies are still booming whilst the U.S. economy founders into recession. Just imagine the higher-growth economies having to raise their interest rates for domestic reasons while the U.S. economy is mired in stagflation. Historically, by the way, that occurrence is not unknown or unusual. Actually, such a scenario has some probability.

## INTERNAL AND EXTERNAL FUNDAMENTALS OF CURRENCIES

Now to the longer run. Over the long-term, the strength of a currency depends on the health of the underlying economy. In that regard, one might remember how the hard currencies became hard currencies. There were both supply-side and demand-side causes. On the supply-side were the characteristics of high savings, high investment and high productivity growth. Evident on the demand-side was greater monetary and fiscal discipline as compared to the rest of the world.

Do these feature apply to the United States, Canada, Australia or any other high-interest, high-deficit country today? Putting it differently, how much healthier is the U.S. economy today than it was in the 1970s? Measured by aggregate GNP growth, the U.S. economy gives the appearance of a superior economic performance. But most of it accrued from population and corresponding labour force growth.

To make a meaningful international comparison, it is first necessary to adjust GNP data for the effect of differing demographic trends. After such adjustment, however, one finds that U.S. GNP growth per employee, capital investment, productivity improvement and living standards trends are among the lowest of all industrial countries.

It is a fact that the U.S. economy has delivered the lowest productivity gains among industrial nations during the whole post-war period. The primary reason has been strong population and labour force growth coincident with record-low savings and investment. In the 1970s, as explained in the last letter, productivity growth had virtually collapsed.

Because of this disastrous productivity trend, it was the declared central goal of the Reagan "supply-siders" to boost savings and investment in order to restore productivity growth. Not only has Reaganomics totally failed in this advertised objective, it has actually made matters worse in the process of trying to make them better. American capital formation is in shambles as never before. National savings (personal and business savings minus the federal budget deficit) have fallen from 7.9% of national income in the 1970s to 2.1% of national income today.

**Internal Manifestations in the U.S. Economy.** This steep decline in available savings had its counterpart in still lower investment. U.S. net investment has fallen to 4.7% of GNP in the 1980s from its already low level of 6.7% in the 1970s. But the worst part of this decline in investment is that it centered on business investment.

Net business investment averaged 3.3% from the 1950s to the early 1970s. In 1982, the last recession-year, it was down to 2.1%. Although the economy began to recover by 1983, net business investment sank to 1.3%. While the economy surged back to new highs, net business investment recovered very little. After a brief rise to 2.5% in 1985, it was down again to 1.6% in 1987.

But, this paltry figure also includes commercial building and inventories. The real crunch has occurred in the industrial portion of manufacturing capacity. In general, corporations have barely managed to invest the cash flows represented by rising depreciation allowances. During the 1980s, U.S. net manufacturing investment was zero. That qualifies as the most pronounced shortfall in capital accumulation in American history.

In the materials producer sector, this capacity decline has been even more catastrophic. Since 1982, capacity has actually contracted about 1% per year and compares negatively with the long-term growth trend of 3.6% per annum in the past. Altogether, the capital stock of this large industrial sector declined by 6% over the recent recovery period. Here's a prime example of capital consumption with a vengeance.

It is often argued that high interest rates have had little or no effect on the U.S. economy. Again, it is rather regarded as proof of superior dynamism. To believe that would be a gross error. Measured in terms of aggregate GNP growth, it may look that way, but in reality high interest rates, especially in combination with an overvalued currency, have deeply impacted the whole production and investment structure of the U.S. economy.

On closer inspection, it is evident that there have already been two main effects. First, in terms of GNP composition, there has been a drastic shift away from investment towards consumption; and second, a disproportionate rise in the type of short-lived investment for which interest costs are relatively unimportant. In the last analysis, what is obvious is that the production and investment structure of the U.S. economy has been adjusting to the growing scarcity of savings.

The result is a disproportionate expansion of labour-intensive service sectors that are neither sensitive to high interest rates or exchange rate, while capital-intensive output (mainly manufacturing output) is retarded. If labour is willing to accept the low wages that are inherent to low-productivity employment, the economy may still expand despite a capital shortage, but of course, at the expense of receding living standards.

#### **PAST TRENDS HAVE LONG-TERM EFFECTS**

Nowadays, it's fashionable to think of nothing else than next week's or next month's economic statistic. Many people may admit that a dearth in capital investment could have certain negative implications for the U.S. economy over the longer term. But, they then assume that it doesn't matter in the short term. The trouble with this soothing argument is that - to quote Mr. Alan Greenspan - that the long run is rapidly turning into the short run.

Ultimately, poor capital formation cannot fail to erode productivity growth. Alarming, in the absence of productivity

growth, it is taken for granted that the present flare-up of inflation is merely a temporary late-cycle phenomenon. But, the extremely weak growth of the capital stock during the 1980s also points to poor productivity growth in the longer run. Apparently, what minor productivity gains there were in recent years was largely or entirely the result of a cyclical recovery from the depths of an unusually deep recession.

To make things worse, flagging productivity growth now coincides with another feature that is sure to add to an underlying inflation bias. Labour supply, after a period of very rapid growth, is now slowing. Between 1976 and 1986, the number of workers aged 20-34 grew by 11 million. Between 1986 and 1996, this category will shrink by some 5 million. That may set the stage for wage-push inflation.

Given a near cessation of productivity growth and the prospect of sharply lower labour-supply growth, one must conclude that the future growth potential of the U.S. economy's may be considerably curtailed. An annual economic growth rate of 2% along with a wage-push that keeps inflation around 5% may both turn out to be long-term trends.

#### THE QUESTION OF A SOFT-LANDING

The key question for the near-term, of course, is whether the Fed will manage to bring inflation down without pushing the U.S. economy into recession. In other words, will it be a soft or a hard-landing? The central condition to the achievement of a soft-landing would be that inflation starts to recede in tandem with economic growth, thus allowing the Fed to ease quickly and, if necessary, aggressively.

That is what happened in 1984-85. After a pause, the U.S. economy took off again. Why couldn't that happen again this time? Because, in comparison to that time, today's economic conditions are as different as night and day. In 1984/85, markets were reassured by declining inflation. On the consumer level, inflation receded from above 5% to well below 4%. Producer prices slid from over 3% to less than 1%, and commodity prices tumbled as the world economy was weak. In that favourable price climate, the Fed could ease aggressively to support the economy. And that is precisely what the Fed did. Even the steeply declining dollar was generally welcomed as desirable and constructive.

1989 is a year of accelerating inflation everywhere. A booming world economy has boosted commodity prices. On its way up, U.S. price inflation has reached levels where both the public and the financial markets have become highly sensitive to any further rise. Any false movement by the Fed could throw the markets into turmoil. And note that the signs of accelerating inflation have emerged even with a strong dollar. In short, the situation couldn't be more different.

On top of all this, it is important to see that rising inflation in the United States cannot be dismissed as being merely the result of either temporary or cyclical factors. A sharply tightening labour market and lagging productivity growth now adds an underlying long-term bias to the upside.

Perversely, accelerating inflation now tends to strengthen the U.S. dollar over the short run on the assumption that interest rates will remain high or rise further. The critical point for the dollar and financial markets will come if and when the U.S. economy decelerates abruptly even while inflation stays high. Then, at the very least, investors will begin to sense the inevitable conflict between an eventual economic slump and embedded inflationary pressures.

#### SUMMARY AND CONCLUSION

Undoubtedly, the main force bolstering the U.S. dollar has been the rise in short-term interest rates relative to those in Germany and Japan. For the time being, all high-yielding currencies are enjoying the same phenomenon and are being bought aggressively.

But the recent lessons of the Australian dollar and the British pound should not be forgotten. The cumulative effect of a foreign capital dependency creates potentially volatile instabilities for these currencies, especially after an extended phase of foreign "hot money" inflows into the fixed income instruments of these countries. These currencies become vulnerable to bad news. One cannot know which event will finally snap market sentiment, kicking the whole process into reverse which then feeds on currency weakness instead.

In any case, the economic and trade news for many of the high-yielding countries are going from bad to worse. In a more normal world, a weakening economy characterized by a deteriorating trade balance and escalating or high inflation would have caused a currency crisis regardless of interest rate levels. This time, these developments have not yet broken the magic spell of high interest rates.

There is a disjunction between psychology and reality as never before. Apparently, what is needed to break the international mania for high interest rates - a mania that totally disregards the fundamentals of currency valuation and risk - is some kind of bone-jarring news on the economy or trade that will awaken markets from their transcendental state of euphoria.

Earlier, we said that one should distinguish between three different influences impacting the fortunes of the dollar: market psychology, cyclical and monetary conditions, and internal and external fundamentals. There is little question that psychological factors are still highly favourable for the dollar. Most foreign investors still cannot conceive of anything possibly getting in the way of the U.S. economic locomotive.

So far, worsening news on the U.S. economy is still largely shrugged off as either insignificant or inconclusive. While there appears to be a growing consensus that some kind of a slowdown is under way by late this or early next year (even a few now predict a recession), any such slowdown or recession is expected to be "mild" - a kind of salutary recession in which business will cool off just enough to dampen inflation, but not enough to hurt employment, sales and profits. It's the "all-news-is-good-news" syndrome.

In our view, the second major influence that still supports the dollar is the credibility of the Fed. There is a perception that monetary policy will stay tight until inflation is tamed and that then a soft landing will ultimately ensue. After such a long recovery, the possibility of a severe recession is complacently discounted. But clearly, cyclical and monetary conditions are deteriorating.

Very probably, the Fed will stay tight as long as it can. But, that makes a recession all the more certain. And then, when unemployment rises and economic growth ceases, public tolerance for tight money will evaporate even with inflation still around 5%. Though that point may still be months away, it is bound to come. The critical trigger, both for psychology and monetary policy, will be the moment the economy is perceived to be weakening rapidly.

Most alarming, however, is the drastic deterioration of internal and external fundamentals on the supply-side of the U.S. economy. From this vantage point, it must be said that the long-term outlook for the U.S. economy and the U.S. currency is worse than ever. Contrary to intentions, supply-side Reaganomics has been the worst thing that ever happened to the supply-side of the U.S. economy.

But here again market perceptions remain undaunted. Instead, it is argued that external deficits, record-sized capital inflows, and a phenomenal stock market rally reflect nothing but growing economic strength and prosperity. In these matters, one couldn't be more blinded to the grave nature of upcoming economic troubles.

As important as the questions of the possible timing and depth of the coming cyclical downturn might be for the U.S. economy, what's even more important is the question of how years of over-consumption, under-saving and under-investment have affected the long-term growth potential of the American economy. A strong and long cyclical upswing has diverted attention away from the heavy and lasting damage that has been inflicted on the supply side of the U.S. economy. But, once recession arrives, the true, deep-seated weaknesses of the U.S. economy will be brought into full view.

It goes without saying that this long period of record-low investment presages an even poorer productivity performance than in the past - with bleak consequences for living standards, inflation and external adjustment.

President Bush wants the U.S. economy to grow out of its problems, including the trade deficit. That's a great idea. Only the question is how? Will it be done through easy money and credit expansion or by greater capital formation and productivity growth? It's certainly possible - at least in the longer run. But that eventuality would require a massive shift in the allocation of resources away from consumption towards investment and from consumer-related services to manufacturing. Only the latter alone can deliver higher exports and productivity.

What we see, though, is that high interest rates and high exchange rates push the allocation of resources in exactly the opposite direction, impeding investment and ineffectively restraining consumption.

However bad long-run fundamentals may be for the U.S. economy and the dollar, bullishness and psychology have now become self-fulfilling for the time-being. The markets have found compelling reasons to buy dollars. And as the dollar makes new highs, the charts also look evermore bullish. Given all the excitement and strong momentum, the dollar may very well see DM 2.00. Very likely, we are now seeing the blow-off stage.

And in our view, the Bundesbank and the Bank of Japan may not resist a further rise in the dollar. They may wait until the rally loses some steam. And given their stronger economies, they may well take advantage of the fact that the Fed will be forced to ease monetary policy long before they will need to do so. It is our opinion that the German and Japanese central banks will definitely sit tight until well after the Fed has eased.

In all seriousness, one must grieve the exaggerated pyrotechnics of present-day exchange markets. The more psychology becomes divorced from longer-running fundamentals, the harsher the inevitable return to reality will be, and the more likely the next phase will see a collapse in the U.S. dollar.

Publisher/Editor: Dr. Kurt Richebächer  
Muehlegrasse 33, CH-8001 Zuerich, Switzerland

Annual Subscription:  
SFr. 600.-/US-Dollar 400.- for subscribers outside Europe.

Languages: German/English

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